(12)

No. 96-454

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1996

ASSOCIATES COMMERCIAL CORPORATION,
*Petitioner,*
v.
ELRAY RASH AND JEAN RASH,
*Respondents.*

*On Writ of Certiorari*
*to the United States Court of Appeals*
*for the Fifth Circuit*

# BRIEF OF WASHINGTON LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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## QUESTION PRESENTED

Whether, when a debtor elects to retain a secured creditor's collateral under the cramdown powers of Chapter 13 of the Bankruptcy Code, the amount required to be paid for the creditor's secured claim is limited to the value that the secured creditor could have obtained if it had sold the collateral at foreclosure.

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## INTEREST OF THE AMICUS CURIAE

The Washington Legal Foundation ("WLF") is a non-profit public interest law and policy center based in Washington, D.C., with thousands of supporters nationwide. WLF regularly appears before federal and state courts promoting economic liberty, free enterprise principles, and a limited and accountable government. WLF's Legal Studies Division also publishes monographs and other publications on these topics.

WLF has appeared as *amicus curiae* in numerous cases before this Court involving issues of public importance,

including other bankruptcy cases. *See, e.g.*, *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552 (1990).

WLF believes that the decision below, which is contrary to the decisions of every other court that has considered the issues involved, represents a dramatic departure from property statutory interpretation. WLF believes that the U.S. Bankruptcy Courts should adhere to a conservative and restrained approach when interpreting statutes, should closely follow the "plain meaning" of statutes, and should eschew overly broad policy pronouncements and excessive economic analysis on the purported consequences of such statutes. WLF believes that this judicial restraint will avoid inconsistent decisions and avoid the polarization of bankruptcy law which has occurred throughout the United States.

## STATEMENT OF THE CASE

Washington Legal Foundation adopts the Statement of the Case of the Petitioner.

## SUMMARY OF ARGUMENT

The Fifth Circuit, in contrast to every other circuit that has considered the issue, decided in *Associates Commercial Corporation v. Rash (In re Rash)*, 90 F.3d 1036 (5th Cir. 1996), that when a Chapter 13 debtor elects to retain a secured creditor's collateral, the amount the debtor is required to pay for the creditor's secured claim is limited to the value that the secured creditor could have obtained if it had sold the collateral at foreclosure.



Washington Legal Foundation ("WLF") seeks reversal of *Rash* because this reading of 11 U.S.C. § 506(a) is inconsistent with the plain language of § 506(a). As the dissent in *Rash* states, the decision in *Rash* "dismantles 11 U.S.C. § 506(a)," and substitutes "judicial redrafting" for principled rules of statutory interpretation. *Rash*, 90 F.3d at 1061 (Smith, J., dissenting). The decision in *Rash* invites a level of judicial activism in a crucial area of bankruptcy law (valuation), an area in which Congress has, indeed, spoken with a "plain" voice.

Because the statute is clear, there is no need to examine the statute's legislative history. Nonetheless, the legislative history also supports reversal of the Fifth Circuit's decision because it directs that courts should determine value in light of the purpose of the valuation and the proposed disposition or use of the collateral. Moreover, the Fifth Circuit improperly applied an erroneous economic analysis -- one that improperly placed the interests of debtors over the legitimate interests of secured creditors -- in its misguided attempt to demonstrate that Congress could not have intended the outcome mandated by the plain meaning of section 506(a).

Finally, WLF seeks reversal because this case has potentially serious consequences in its application to business reorganizations under Chapter 11. Indeed, because Chapter 5 of the Bankruptcy Code, in which Section 506(a) is found, applies generally to the operative bankruptcy chapters (Chapters 7, 11, 12 and 13), *Rash's* consequences extend beyond Chapter 13. Accordingly, this case applies not only to trucks retained by consumer debtors, but also to collateral retained by Chapter 11 business debtors and to determinations of adequate protection and confirmations of

"cramdown" plans in Chapter 11 cases. The decision in *Rash* constitutes an unwarranted judicial intrusion into the marketplace and endangers the fair balance between the rights of debtors and creditors.

The goals of predictability, judicial conservatism, and an appropriate balancing of debtor/creditor interests were all injured in *Rash*. Your amicus joins with numerous others in urging this Court to reverse the Fifth Circuit's decision in *Rash*.

## ARGUMENT

### 1. THE FIFTH CIRCUIT ERRED IN ITS INTERPRETATION OF SECTION 506(a) AND DISREGARDED THE PLAIN MEANING OF SECTION 506(a)

#### A. The Fifth Circuit Erroneously Focused on the First Sentence of Section 506(a) and Thereby Ignored the Plain Meaning of Section 506(a)

The question presented to the Fifth Circuit was a narrow one: What is the appropriate method to value collateral that a Chapter 13 debtor proposes to retain in conjunction with a plan of reorganization? The Bankruptcy Code provision governing valuations of collateral is 11 U.S.C. § 506(a), and it provides as follows:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.



The Fifth Circuit in *Rash* was confronted with a seemingly straightforward, but crucial distinction in methods of valuation; should it utilize the "replacement" or "retail" method of valuation,[1] as urged by the petitioner Associates Commercial Corporation ("ACC"), or should it utilize a foreclosure or "wholesale" model for valuation purpose under § 506(a). This choice between liquidation value and retail value "lies at the heart of most disputes over asset valuation in bankruptcy." Chaim J. Fortgang and Thomas M. Mayer, *Valuation in Bankruptcy*, 32 UCLA L. Rev. 1061, 1063 (1985).

Generally, "[i]f an asset is not used as part of a business, or if the business is not viable, the asset is valued at how much it will bring at a sale less the costs of

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[1] The term "replacement costs" does not mean what it costs the Rashes to buy a truck of the same make and model, but rather "the costs to the Rashes of purchasing a hypothetical truck that is identical in all respects -- age, milage and operating conditions -- to the Rashes' truck." *Rash*, 90 F.3d at 1041 n.3. This is known as the "retail" or "replacement cost" method of valuation. *See id.* at 1062 n.1 (Smith, J., dissenting).

disposition -- a liquidation value."[2] Conversely, a "going concern" is a business with some sort of future and requires the use of retail value.[3] The difference in monetary terms between the two is that generally "replacement cost equals an asset's retail price, and foreclosure value equals its wholesale price, which is equivalent to retail price less hypothetical costs of sale." *Rash*, 90 F.3d at 1062 n.1 (Smith, J., dissenting).[4]

The starting point for the analysis of § 506(a) is the statute's "plain meaning." *United States v. Ron Pair Enter., Inc.*, 489 U.S. 235, 240 (1989). "[F]or where, as here, the statute's language is plain, 'the sole function of the courts is to enforce it according to its terms.'" *Id.* The mere fact that opposing parties find contradictory meanings does not render a statute ambiguous, nor lacking in plain meaning.[5]

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[2] Fortgang and Mayer, *supra*, at 1064.

[3] *See* David Gray Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations*, 41 Am. U. L. Rev. 63, 75-77 (1991). Professor Carlson writes, "[E]stimating the value of property is an art, not a science" and that while all of the various formulations suffer from a lack of content, "the choice for hypothesizing market exchanges is usually narrowed down to a choice of going concern value and liquidation value," a choice that confronts most bankruptcy courts. *Id.* at 75.

[4] But, as the dissenting judges in *Rash* pointed out, "the terms 'retail' and 'wholesale' value only loosely describe the replacement and foreclosure approaches." *Id.*

[5] The "plain meaning" that is sought here is not the kind of "pernicious oversimplification" that Justice O'Connor expressed concern over in her dissenting opinion in *Ron Pair* where she cited Justice (continued...)



As the dissent *Rash* stated, "Section 506(a) is not difficult to interpret." *Rash*, 90 F.3d at 1061 (Smith, J., dissenting).[6] The textual debate, to the extent one exists, has involved the relative significance of the first sentence, which focuses on the "creditor's interest" versus the second sentence which focuses on "use and disposition" in determining the property's value. Although there is an apparent "tension" between the two sentences, they can be readily and sensibly reconciled without rendering either sentence meaningless.[7]

As the dissent in *Rash* recognized, the phrase "creditor's interest in the estate's interest in" simply means that a creditor or debtor may have an interest in less than the full value of the collateral. *Rash*, 90 F.3d at 1064 (Smith, J., dissenting). The partial interest occurs where the creditor holds a partial lien on collateral or the debtor has a partial ownership interest in the collateral. *Id.* (Smith, J.,

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[5](...continued)
Frankfurter's observation, "The notion that because the words of a statute are plain, its meaning is also plain, is merely pernicious oversimplification." *Ron Pair*, 489 U.S. at 249 (O'Connor, J., dissenting) (quoting *United States v. Monia*, 317 U.S. 424, 431 (1943) (Frankfurter, J., dissenting)).

[6] Indeed, this is a case that perhaps warrants Justice Scalia's observation that it is difficult to imagine why such an issue should have yielded a circuit split. *See Union Bank v. Wolas*, 502 U.S. 151, 163 (Scalia, J., concurring).

[7] *See*, for example, *In re Claeys*, 81 B.R. 985, 990 (Bankr. D. N.D. 1987), in which the court stated that "[w]hether a valuation is made without regard for potential costs of liquidation depends, it seems, upon the emphasis given to the first and second sentences of Section 506(a)."

dissenting). However, where there is only one creditor and one debtor, the value of the secured claim equals the value of the underlying collateral. *See id.* at 1061, 1064 (Smith, J., dissenting) (citing *United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 372 (1988)).

This Court has consistently construed the phrase "creditor's interest" to be "equal to the lesser of the amount of the lien or the value of the collateral." For example, in *United Savings Association v. Timbers of Inwood Forest Associates*, 484 U.S. 365 (1988), this Court concluded that the phrase "value of such creditor's interest" in § 506(a) means the value of the collateral. *Id.* at 372; *see also Nobelman v. American Sav. Bank*, 508 U.S. 324, 328-29 (1993) (suggesting the same); *United States v. Ron Pair Enter., Inc.*, 489 U.S. 235, 239 (1989) ("Subsection (a) of § 506 provides that a claim is secured only to the extent of the value of the property on which the lien is fixed ...."), *see also, Huntington Nat'l Bank v. Pees (In re McClurken)*, 31 F.3d 401, 404 (6th Cir. 1994).[8]

In *Timbers*, an undersecured creditor moved for relief from the automatic stay to foreclose on its collateral, consisting of an apartment project and the project's rental income. The creditor sought relief from stay on the ground

[8] Also, in a footnote in the *Ron Pair* decision, this Court stated the following: "Thus, a $100,000 claim, secured by a lien on property of a value of $60,000, is considered to be a secured claim to the extent of $60,000, and to be an unsecured claim for $40,000." *Ron Pair Enter.*, 489 U.S. at 239 n.3 (emphasis added). This statement in the Court's own *Ron Pair* decision reinforces the fundamental concept that the phrase "value of such creditor's interest" in Section 506(a) means the value of the collateral.



that its interest in the collateral was not adequately protected. The creditor contended that the right granted by 11 U.S.C. § 362(d)(1) to adequate protection of an "interest in property" entitled it to compensation for the delay caused by the automatic stay in foreclosing on the collateral.

This Court noted that the term "interest in property" certainly summons up such concepts as "fee ownership," "life estate," "co-ownership," and security interest . . . ." *Timbers*, 484 U.S. at 371. Then, in analyzing the same "interest in property" term found in section 506(a), this Court concluded that the term "value of such creditor's interest" simply means "the value of the collateral." *Id.* at 372. Because this finding in *Timbers* excluded from value such other economic components as compensation for lost opportunity costs or other interest payments, it necessarily held that ongoing value is the touchstone. Thus, *Timbers* is significant in construing the two sentences in § 506(a).

The second sentence of § 506(a) provides explicit direction on how to value the collateral. Congress mandated in the second sentence that valuation "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property." 11 U.S.C. § 506(a). Thus, the statute by its very terms directss that the value of the collaterol be determined based on the debtor's use of the property.[9] If the debtor elects to retain and "use" the

[9] Section 506(a) in its text invites a case-by-case analysis of value. As one commentator notes, "Congressional history celebrates the fact that judges are to make the rules for valuation on a case-by-case basis." David Gray Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations*, 41 Am. U. L. Rev. 63, 64 (1991) (footnote (continued...)

collaterol, the appropriate value is the replacements value. If the debtor, instead, elects to "dispose" of the property, the value is the liquidation value.

Numerous courts prior to *Rash* had little difficulty in reconciling the two sentences of § 506(a).[10] In *Wold v. Goldome Realty Corp. (In re Liberty Assocs.)*, 105 B.R. 798 (Bankr. E.D. Pa. 1989), the court reconciled the statute as follows:

> The first sentence requires that the court value the creditor's interest in the estate's interest in the secured property. Thus, the creditor's interest can be ascertained only after the estate's interest is ascertained. As the second sentence dictates, the estate's interest must be measured in light of the disposition and use of the property articulated in the debtor's plan (or, in a Chapter 7 case like *Mays*, in accordance with the debtor's expressed intended future use of the property). Therefore, if

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[9](...continued)
omitted) [hereinafter Carlson, *Secured Creditors*]. Unfortunately, as Professor Carlson further observes, "bankruptcy courts have indeed gratified the wishes of Congress by producing an extremely diverse and contradictory set of valuation theories." *Id.*

[10] The court in *In re Landing Associates*, 122 B.R. 288 (Bankr. W.D. Tex. 1990), reached this result, holding that when the debtor intends to retain property, "it would be artificial to deduct costs that creditor will not incur, so that creditor's interest should be determined without consideration of hypothetical liquidation costs." *Id.* at 294; *see also* Carlson, *Secured Creditors*, *supra*, at 101 n.191 (citing numerous other bankruptcy court decisions reaching similar conclusions).



> the debtor plans to retain the property valued under § 506(a), we do not believe that it is proper to factor in hypothetical sales costs.

*Id.* at 804 (footnote omitted) (citing *In re Mays*, 85 B.R. 955, 964 (Bankr. E.D. Pa. 1988), *aff'd*, 1988 WL 81716, 1988 U.S. Dist. LEXIS 8427 (E.D. Pa. Aug. 1, 1988)); *see also Brown & Co. Securities Corp. v. Balbus (In re Balbus)*, 933 F.2d 246, 248-49 (4th Cir. 1991) (concluding that the first sentence of Section 506(a) merely replicates the second sentence).

In contrast to these well-reasoned decision, *Rash* reads the second sentence of § 506(a) out of the statute in violation of this Court's admonition to give effect in construing a statute to each word in the statute. *Reiter v. Sonotone Corp.*, 442 U.S. 330, 339 (1979); *see also Timbers*, 484 U.S. at 371-72 (stating that statutory construction is a "holistic endeavor"). In rendering the second sentence of § 506(a) as surplusage, *Rash* robs courts of the flexibility that Congress granted the courts when valuing collateral. *See Winthrop Old Farm Nurseries, Inc. v. New Bedford Institution for Sav. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72, 75 (1st Cir. 1995). If *Rash* correctly interprets § 506(a), then a debtor's proposed use of collateral can never be relevant in valuing the collateral since the value will always be set at the liquidation or foreclosure sale value.

Applying liquidation value here ignores the fact that the purpose of valuing collateral in a reorganization is to determine value where the debtor retains and continues to use the collateral. Where the debtor proposes to retain the collateral, the value to the debtor is the collateral's

replacement cost, without deducting nonexistent transaction costs. In *In re Taffi*, 96 F.3d 1190 (9th Cir. 1996), which was decided after *Rash*, the Ninth Circuit stated:

> When a Chapter 11 debtor or a Chapter 13 debtor intends to retain property subject to a lien, the purpose of a valuation under section 506(a) is not to determine the amount the creditor would receive if it hypothetically had to foreclose and sell the collateral. Neither the foreclosure value nor the costs of repossession are to be considered because no foreclosure is intended. Instead, when the proposed use of the property is continued retention by the debtor, the purpose of the valuation is to determine how much the creditor will receive for the debtor's continued possession. Hypothetical sales costs are not to be considered because no sale is intended.

*Id.* at 1192. The Ninth Circuit's decision in *Taffi* is brief and concise, finding nothing complex nor troublesome about the text of § 506(a).

The First Circuit reached the same conclusion in *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72 (1st Cir. 1995) in which it held that "a court remains faithful to the dictates of section 506(a) by valuing the creditor's interest in the collateral in light of the proposed post-bankruptcy reality: no foreclosure sale and economic benefit for the debtor derived from the collateral equal to or greater than its fair market value." *Id.* at 75.



Where the debtor elects to retain the collateral, there is no foreclosure. Because the debtor, not the creditor, controls the decision whether to retain or dispose of the collateral, the debtor is given the right to determine how to maximize value. Thus, by proposing to retain and use the collateral, the debtor exercises this choice and acknowledges that the collateral has greater value than if the collateral is liquidated. *See Metrobank v. Trimble (In re Trimble)*, 50 F.3d 530, 531 (8th Cir. 1995).[11]

Only the Fifth Circuit has held that where the debtor proposes to retain collateral, that value is determined by what a creditor would receive in a hypothetical, non-existent, foreclosure sale. The plain meaning of the statute does not require any judicial policy making to find a "truer meaning." The temptation to tamper with the Bankruptcy Code for economic policy reasons (discussed below) should be eschewed. As the dissent in *Rash* states:

> The majority dismantles 11 U.S.C. § 506(a) by combining a question-begging interpretation of the statute's first sentence with an unreasonably restrictive reading of the second. Having thereby obscured the section's plain meaning, the majority turns to an inapposite presumption, an incorrect

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[11] The Fourth and Sixth Circuits have reached the same result. *See Huntington Nat'l Bank v. Pees (In re McClurkin)*, 31 F.3d 401, 405 (6th Cir. 1994) ("We ... hold that, where the debtor proposes to retain the collateral under a reorganization plan, § 506(a) does not require or permit a reduction in the creditor's secured claim to account for purely hypothetical costs of sale."); *Coker v. Sovran Equity Mortgage Corp. (In re Coker)*, 973 F.2d 258, 260 (4th Cir. 1992) (stating that hypothetical costs of sale may not be deducted when a debtor retains collateral).

> economic analysis, and the last resort of judicial redrafting-- selective reading of the legislative history. Not surprisingly, this policy-driven reconstruction of the statute has been squarely rejected by every other circuit that has considered it.

*Rash*, 90 F.3d at 1061 (Smith, J., dissenting).

The dissent highlights *Rash's* consequences. *Rash* violates the Court's continued efforts to respect and confine itself to the plain language of a statute -- not only as a means of determining Congress' intent, but more broadly in assuring integrity in the respective roles of the courts as they review and interpret statutes.[12]

B. While this Court Need Not Examine the Legislative History, the Legislative History Supports the View that Value Should be Predicated on Use and Disposition, Not On a Hypothetical Liquidation.

Because § 506(a) yields a plain and sensible meaning, this Court need not examine the legislative history to ascertain the intent of Congress. *Toibb v. Radloff*, 501 U.S. 157, 162 (1991) (stating that legislative history may be considered to resolve statutory ambiguity); *Ron Pair Enter., Inc.*, 489 U.S. at 240 ("[A]s long as the statutory scheme is

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[12] The deviation in *Rash* from uniformly accepted plain meaning and the Fifth Circuit's explicit willingness to add policy overlays, calls to mind Justice Scalia's observation in his concurrence in *Patterson v. Shumate*, 504 U.S. 753, 766 (1992), that where courts depart from attention to text, there is a risk that we will no longer be able to fairly think of ourselves as a government of laws, rather than of men.



coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute."). Nevertheless, should this Court examine the legislative history, the history supports the conclusion that value is to be determined by the collateral's use and disposition.

The legislative history to § 506(a) provides in pertinent part as follows:

> While courts will have to determine value on a case-by-case basis, the subsection makes it clear that valuation is to be determined in light of the purpose of the valuation and the proposed disposition and use of the subject property. This determination shall be made in conjunction with any hearing on such disposition or use of property or on a plan affecting the creditor's interest. To illustrate, a valuation early in the case in a proceeding under sections 361-363 would not be binding upon the debtor or creditor at the time of confirmation of the plan.

S. Rep. No. 989, 95th Cong., 2d Sess. 68 (1978), reprinted in 1978 U.S.C.A.A.N. 5787, 5854. This passage reinforces the fact that the courts should conduct valuations on a case-by-case basis in light of the "purpose of the valuation" and the proposed "disposition or use" of the collateral. It is nonsense, then, for the Fifth Circuit to suggest that Congress intended the courts to use a liquidation or foreclosure value in all cases and under all circumstances, regardless whether the liened property is to be sold, or retained and used by the debtor.

The legislative history relied upon by the Fifth Circuit in *Rash* did not deal directly with § 506(a), unlike the passage above, but rather addressed other provisions of the Bankruptcy Code that hardly offer guidance as to how a § 506(a) valuation should be conducted. For example, the Fifth Circuit looked to portions of the House report dealing with 11 U.S.C. § 722, the Bankruptcy Code provision authorizing debtors to redeem liened property from secured creditors. *Rash*, 90 F.3d at 1057. The Fifth Circuit quoted the passage in the House report, stating that § 722 is intended to allow debtors "to retain "necessary property" and "avoid high replacement costs," and surmised from there that the courts should not use a replacement cost or "retail" value under § 506(a). *Id.* (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 127 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 6088).

But as the dissenting judges pointed out in *Rash*, a redemption under § 722 is essentially a liquidation sale of the property from the secured creditor to the debtor. The debtor is not holding and using property over time, as the debtor would in a Chapter 13 reorganization, while slowly paying the creditor in regular installments. Additionally, the legislative history's reference for "avoid[ing] high replacement costs" is not a mandate for using a liquidation or foreclosure value. Indeed, the replacement value method is wholly consistent with avoiding such high costs. The replacement method of valuation simply provides that

> a creditor cannot demand the collateral's original purchase price -- only its replacement cost in its current condition. To borrow the House report's illustration, the replacement approach does not permit [the creditor] to demand the $2000 that the



> debtor paid for new silverware and china; instead, he can demand only the $200 that the debtor would have to pay for a used set. The replacement approach means only that we cannot further deduct the hypothetical cost of selling the used goods.

*Rash*, 90 F.3d at 1070 (Smith, J., dissenting).

Also misplaced is the Fifth Circuit's emphasis on a passage of the House report, indicating that Congress enacted Chapter 13 in 1978 to curb "extraneous and non-financial pressures imposed by secured creditors" that allegedly enable them to recover more from the debtor than the property is worth. *See id.* at 1056 (citing H.R. Rep. No. 595, 95th Cong., 1st Sess. 124 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 6085). But the reforms enacted under Chapter 13 were designed to prevent secured creditors from refusing to participate in Chapter 13 plans. Under the old law, "[n]o matter how little the collateral was worth, a secured creditor could demand repayment of the original purchase price or refuse to participate in the plan," thereby gaining undue leverage over debtors. *Id.* at 1070 (Smith, J., dissenting).

Under the reformed Chapter 13 that was enacted with the 1978 Bankruptcy Code (and still in effect), debtors can force secured creditors to participate in their reorganizations. The one "reform" or "change" mentioned in the legislative history is that the courts are to "value the secured creditor's interest" -- a restatement of section 506(a), and accordingly, a rather unremarkable proposition. *See Rash*, 90 F.3d at 1056 (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 124 (1977), reprinted in 1978 U.S.C.C.A.N. 5787 6085).

What this emphasis on high replacement costs means is that, in cramdown situations where the debtor is proposing to retain and use the property, the court should measure the current value of the collateral, and not adopt the original purchase price. *See id.* at 1071 (Smith, J., dissenting). The passage quoted by the Fifth Circuit majority does not mean that courts can reduce the value of the collateral by deducting hypothetical liquidation costs, when the debtor is proposing to keep the property, and therefore no liquidation or foreclosure is taking place.

C. The Fifth Circuit Improperly Applied an Erroneous Economic Analysis to Demonstrate That Congress Could Not Have Intended the Outcome Suggested by the Plain Meaning of Section 506

It is axiomatic that "[t]he plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.'" *Ron Pair Enter., Inc.*, 489 U.S. at 242 (quoting *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982)). Perhaps with this principle in mind, the Fifth Circuit in *Rash* sought to demonstrate that its interpretation of the "plain meaning" of § 506(a) resulted in the outcome that Congress intended. *Rash*, 90 F.3d at 1071 (citing *Ron Pair*, 489 U.S. at 242-23). The Fifth Circuit should not have conducted this analysis and, in any event, the analysis it conducted is simply wrong.

The Fifth Circuit's economic theories are neither analytically sound nor methodologically appropriate. Circuit Judge Smith correctly cautioned that an excessive attempt by courts to divine and apply correct economic consequence



interpretation as a methodology of statutory interpretation may lead to "judicial tampering." *Id.* at 1071. The reference to external economic theory leads to a lack of a coherent methodology.

Assuming *arguendo* that economic analysis is warranted in order to divine Congress's intent, the court's analysis in *Rash* contains two key fallacies. *Rash* erroneously states that valuing collateral at retail (1) does not create the potential for debtors to reap a windfall, and (2) amounts to a bonus for secured creditors. In fact, valuing collateral at wholesale amounts to a bonus for both unsecured creditors and debtors and creates the potential for debtors to reap windfalls.

*Rash* effectively reduces the secured creditor's claim to the collateral's liquidation value that the creditor could obtain through foreclosure and strips the secured creditor of the value to which it is entitled on account of the debtor's retention of the collateral. As a result, *Rash* impermissibly engages in redistributing value from secured creditors to debtors and unsecured creditors[13] This shifting of wealth violates the longstanding bankruptcy policy of preventing a party from receiving "a windfall merely by reason of the happenstance of bankruptcy." *Butner v. United States*, 440

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[13] *See* Thomas H. Jackson and Robert E. Scott, *Symposium on the Law and Economics of Bargaining: On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 Va. L. Rev. 155, 155-56 (1989), in which the authors state that "[t]he cornerstone of the creditors' bargain is the normative claim that prebankruptcy entitlements should be impaired in bankruptcy only when necessary to maximize net asset distributions to the creditors as a group and never to accomplish purely distributional goals."

U.S. 48, 55 (1979). Outside bankruptcy, if the debtor retains and uses the collateral, the secured creditor is entitled to receive the agreed-upon payments from the debtor (which is usually more than the liquidation value).

In the long run, secured and unsecured lenders may change their lending requirements or interest rates to compensate for the value transfer that *Rash* imposes. As the dissent in *Rash* stated:

> The choice between the foreclosure and replacement approaches does favor either secured or unsecured creditors vis-a-vis the other, however. The foreclosure approach benefits unsecured creditors by reducing the value of secured claims, thereby freeing up more money for unsecured claims; the replacement approach does the opposite. Both types of creditors can largely compensate for either result by adjusting their interest rates or other lending practices, such as down payment requirements, accordingly. As a result, adoption of either rule will produce counterbalancing effects on the interest rates charged by secured and unsecured creditors, resulting in little net effect on consumers.

*Id.* at 1064 (citation omitted). Nonetheless, § 506(a) does not invite courts to transfer value from secured to unsecured creditors.

Neither does § 506(a) invite courts to transfer value from secured creditors to debtors. Yet the *Rash* decision issues such an invitation, and, in Chapter 13 cases, will result in a windfall for debtors. The Bankruptcy Code only



requires that Chapter 13 debtors pay projected disposable income to unsecured creditors for a three year period. 11 U.S.C. § 1325(b)(1)(B). Debtors will benefit from *Rash* by reducing obligations owed secured creditors whose payments can exceed the three year period and whose obligations must be repaid with interest, and leave debtors liable only to pay unsecured creditors for three years without interest. *Rash's* economic analysis constitutes an unwarranted intrusion by courts into the market place.

The majority in *Rash* mistakenly rejected ACC's contention that applying liquidation value creates the potential for debtors to reap a windfall. Indeed, *Rash* increases the risk of "debtor-arbitrage." Wholesale collateral valuations will enable "debtor arbitrage" by which debtors can resell assets at higher prices, thereby capturing the equity for themselves. *See* David Gray Carlson, *Undersecured Claims Under Bankruptcy Code Sections 506(a) and 1111(b): Second Looks at Judicial Valuations of Collateral*, 6 Bankr. Dev. J. 253, 266-67 (1989). As Professor Carlson stated, "The ability of a debtor to arbitrage between low bankruptcy court valuations and real market prices has been confirmed by two court of appeals decisions." *Id.* at 266.

Similarly, *Rash* will result in a transfer of value from secured creditors to debtors in Chapter 11 cases. One hallmark of the Bankruptcy Code's framework is that it fosters negotiated settlements especially in Chapter 11 cases. By stripping secured creditors of collateral value, *Rash* will result in additional value for debtors and unsecured creditors to divide in Chapter 11 cases.

None of the economic theorizing of the Fifth Circuit was warranted; the plain meaning of section 506 was and is sufficient. The Fifth Circuit should have avoided this foray into the murkier waters of economic modeling and forecasting.

## II. *RASH* TREATS SECURED LENDERS IN CHAPTER 11 CASES UNFAIRLY AND WILL INJURE WELL-DEVELOPED NOTIONS OF ADEQUATE PROTECTION

### A. The Use of Liquidation Value Under Section 506(a) is Inconsistent with the Theories of Adequate Protection and This Court's Ruling in *Timbers*

Although Chapter 5 of the Bankruptcy Code applies generally to the operative bankruptcy chapters (Chapters 7, 11, 12, and 13), the Fifth Circuit in *Rash* incorrectly concluded that its ruling will not affect cases filed under



Chapter 11.[14] In fact, the methodology implemented by the Fifth Circuit will apply far beyond the Chapter 13 context.

The Fifth Circuit's statement that its analysis does not apply to other chapters of the Bankruptcy Code fails. Indeed, this Court's analysis of § 506(a) will apply as much to the valuation of accounts receivable in Chapter 11, 12 and 13 cases as it will to vehicles in Chapter 13 cases. The underlying premise of the Fifth Circuit's ruling is that the "starting point" (as well as the ending point) under § 506(a) is what the creditor could realize if it sold the estate's interest in the property according to the security agreement.

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[14] The court in *Rash* incorrectly stated:

> Finally, our reference in *Timbers* to the benefits that inure to secured creditors from going-concern valuations must be placed in context. In Chapter 11 cases, a going-concern valuation of the reorganized debtor is a necessary step in applying the "fair andequitable" standard to a class of unsecured claims or a class of interests in a cram down under § 1129(b). It is not uncommon for a secured creditor to assert that the amount of its secured claim should be augmented by a portion of this going-concern value. Indeed, consensual plans under Chapter 11 sometimes, in effect, allocate some of this value to the secured claims. Whether the secured creditors are entitled to this value as a matter of law or equity is not at issue in this case and we express no opinion on it. <u>In any event, the Chapter 11 requirements mandating the going-concern valuations mentioned in Timbers do not have an analog in Chapter 13</u>.

*Id.* at 1053 n.23.

*Rash*, 90 F.3d at 1044. This premise is inconsistent with well-developed concepts of value that lie at the heart of Chapter 11 reorganizations and adversely impacts the well-defined case law regarding adequate protection.

Courts have consistently construed the value of property retained by Chapter 11 debtors to mean on-going value. A leading, early decision regarding adequate protection and its relationship to "lost opportunity costs" is *In re South Village, Inc.*, 25 B.R. 987 (Bankr. D. Utah 1982), which pre-dated yet anticipated much of this Court's analysis in *United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365 (1988). In *South Village*, the court reasoned that creditors could not recover both lost opportunity costs <u>and</u> ongoing value through adequate protection payments. Restated, since the premise of adequate protection mostly is predicated on "value" as being ongoing value, the creditor cannot seek payment for the loss of the ability to sell the collateral and re-invest the proceeds. *South Village*, 25 B.R. at 995.

*South Village's* analysis of "value," as in all bankruptcy analyses, begins with section 506(a), regardless whether the issue arises at a plan confirmation hearing in a Chapter 13 case or in connection with an award of adequate protection payments in a Chapter 11 case. *South Village* as well as the dissenting judges in *Rash* recognize that "[i]t is not the contract but the <u>use</u> which fixes the value...." *Id.* at 995 n.12. The analysis in *South Village* is in accord with the analysis in *Timbers* where this Court recognized that ongoing value, not liquidation value, governs determinations regarding adequate protection. This Court stated: "In subsection (a) of this provision the creditor's "interest in property" obviously means his security interest without



taking account of his right to immediate possession of the collateral on default." *Timbers*, 484 U.S. at 372.

If the Fifth Circuit's interpretation of § 506(a) is correct, then courts can apply liquidation values not only for plan confirmation purposes, but also for adequate protection purposes, thereby resurrecting the issue of entitlement to lost opportunity costs, which this Court resolved in *Timbers*.

B. The Use of Liquidation Value in Section 506(a) Will Lead to Cramdown Losses to Secured Creditors Under Section 1129(b)

Bankruptcy courts agree that going-concern value must be utilized in a Chapter 11 reorganization, unless the plan is specifically a liquidation plan. Judge Norton's admonition about fish and fowl in bankruptcy is perhaps the most colorful description of this concept. He stated:

> Having declared itself to be a fish to be reorganized, it would be inconsistent for the court now to permit the debtor to declare itself a fowl to be liquidated for purposes of "cramming down" a lower "appraisal" value upon the secured creditors. Therefore, a liquidation value, <u>i.e.</u>, a foreclosure value, is a procedure totally foreign to this matter and not a proper standard for valuation.

*In re Pine Gate Assocs.*, 12 C.B.C. 607, 624 (Bankr. N.D. Ga. 1977)).[15]

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[15] *See* Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C. L. Rev. 925, 939 (1980)(stating that (continued...)

Section 1129(b) contains the "cramdown" provision of Chapter 11 which enables debtors to reduce their secured obligations to equal the value of the collateral which secures the obligations. The section provides that the holder of an allowed secured claim must receive "on account of such claim deferred cash payments totalling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property." 11 U.S.C. § 1129(b)(2)(A)(i)(II) (emphasis added). The phrase used for determining payments to be made to a secured creditor under a Chapter 11 plan is essentially the same phrase found in section 506(a)'s first sentence. These same phrases cannot mean liquidation value when applied in Chapter 13 cases and retail value when applied in Chapter 11 cases. In *Timbers*, this Court recognized the connection between §§ 506(a) and 1129(b)(2)(A)(i)(II) where it stated:

> It is true that under § 1129(b) a secured claimant has a right to receive under a plan the present value of his collateral. This entitlement arises . . . from the provision of § 1129(b)(2)(A)(i)(II) that guarantees the secured creditor "deferred cash payments . . . of a value **as of the effective date of the plan**, of at least the value of such [secured claimant's] interest in the estate's interest in such property."

[15](...continued)
"[i]t is incongruous to value a business that is being reorganized on the basis of the price its assets could fetch on a piecemeal liquidation when the entire theory of the reorganization is that the debtor is being preserved as a going concern").



*Timbers*, 484 U.S. at 377 (emphasis in original). If this fundamental phrase, which pursuant to section 506(a) applies to Chapters 7, 11, 12 and 13, means liquidation value in Chapter 13 reorganizations, then it must also mean liquidation value in Chapter 11 reorganizations.

If *Rash* is affirmed, then in Chapter 11 reorganization cases, where the debtor will retain the operating assets, the allowed secured claim will be measured not by going concern value, but by liquidation value. Capping allowed secured claims at liquidation value will have two effects. First, it will result in a transfer of value from secured creditors to the debtors. As noted above, the Bankruptcy Code's balancing of rights often results in negotiated Chapter 11 plans. Reducing allowed secured claims in reorganizations to liquidation value will shift the balance in favor of debtors and will provide debtors with additional leverage which will enable them to retain more value in Chapter 11 reorganizations. Second, it will decrease the amount paid to the secured creditors, and increase the return to unsecured creditors effectively shifting wealth from partially secured creditors to unsecured creditors. Surely, this was not Congress' intent in drafting Section 506(a) and no economic interpretation ought to lead to this result.

## CONCLUSION

For all of the reasons set forth above, your amicus respectfully requests that the decision below be reversed.

Respectfully submitted,

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